BENCHMARKS AND INDICES

Issue Brief

Benchmarks and indices serve a key role in financial markets. They function as portfolios for investors seeking passive exposure to a particular market segment, serve as performance standards against which to measure the value generated by active managers, act as proxies for asset classes, and provide a reference point for determining the price or value of various financial instruments or transactions.

However, issues regarding the integrity of certain interest rate benchmarks have come to light, including the London Interbank Offered Rate (LIBOR) and the European Interbank Offered Rate (EURIBOR). LIBOR is the most frequently referenced interest rate globally, underpinning transactions with a notional outstanding amount of at least $300 trillion ranging from derivatives to various credit products.

Since 2009, regulators in the United Kingdom, along with authorities in the United States, Canada, Japan, Switzerland, and the European Union, have been investigating a number of institutions for alleged misconduct relating to the setting of LIBOR and other similar benchmarks. Among these investigations, Barclays was fined £291 million ($451 million) by U.K. and U.S. regulators for manipulating its LIBOR submissions. Similarly, UBS and Royal Bank of Scotland paid settlements of $1.5 billion and $610 million, respectively, for their part in manipulating LIBOR.

As a result of these scandals, regulators globally are working to establish principles or regulatory frameworks for the production and use of benchmarks in financial contracts.

More broadly, market manipulation of benchmarks can extend beyond LIBOR and EURIBOR — any benchmark or index is potentially subject to manipulation. For example, commodities markets benchmarks are particularly vulnerable to manipulation. The issues related to LIBOR and EURIBOR are acute, however, because the rates underlying these benchmarks are based on judgment and are not anchored in observable market transactions.

In addition to data subjectivity and opacity, other vulnerabilities associated with benchmark data inputs include voluntary submission and continuity of benchmark participation (i.e. the willingness to participate on an ongoing basis). These vulnerabilities can create sample selection biases, such as survivorship bias, which can dilute the integrity of a benchmark. Other vulnerabilities include benchmarks where administrators exercise discretion over index composition or the rebalancing of constituents, and where the size and composition of a panel (i.e., the data contributors) may not be representative of the underlying market.

For a benchmark to be credible and useful to investors, it must fairly and accurately represent the key attributes of the market segment or financial instrument in question.

In particular, benchmarks should be investable, measurable (with some frequency for performance attribution), appropriate, reflective of current investment opinions, specified in advance (publicly known at the start of an evaluation period where possible), and owned (i.e. there is appropriate accountability).
Policy Developments

In July 2012, the European Commission amended its proposals for the Market Abuse Directive and Regulation to clarify the inclusion of any manipulation of benchmarks within the scope of administrative or criminal sanctions.

Following the announcement of the Barclays settlement, the U.K. government tasked Martin Wheatley, head of the U.K.’s Financial Conduct Authority, to conduct a review into LIBOR. The “Wheatley Review”, published in September 2012, called for banks’ LIBOR submissions to be explicitly supported by actual transaction data, along with a new code of conduct over submissions to establish standards over the rate-setting process. That code of conduct will be drawn up by a new administrator who will take over from the British Bankers Association. Other measures included limiting the production of LIBOR to only those currencies and tenors where there is a liquid underlying market and encouraging more banks to participate in the LIBOR process to reduce the influence of any one bank in the calculation of the benchmark. The submission to, and administration of, LIBOR, will also be regulated, and the regulator will have powers to pursue criminal sanctions where appropriate.

In November 2012, the European Commission launched a consultation examining the purpose, production, and use of financial benchmarks generally, in addition to governance and transparency considerations associated with benchmarks. It is expected that this consultation process will lead to a legislative proposal on benchmarks and indices being published in the summer of 2013.

In addition to these legislative and regulatory developments, European and international regulators have also been working on developing principles for benchmark-setting processes. These initiatives seek to establish international consistency and to ensure that best practices are adhered to in the interim period pending the publication of legislative proposals at the European level.

In January 2013, the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) conducted a review of EURIBOR’s administration and management and issued recommendations to the EURIBOR-European Banking Federation (EBF), the trade association that oversees the benchmark, to improve the governance and transparency of the rate-setting process. Additionally, the EBA issued recommendations to national authorities on the supervisory oversight of banks participating in the EURIBOR panel.

Alongside this review, ESMA-EBA published a consultation on Principles for Benchmark Setting Processes in the EU which establishes a framework for the conduct of benchmark rate-setting and the activities of participants in the process. It is expected that ESMA-EBA’s final principles will be published in spring 2013, and will apply during the period through which the EU’s legislative proposals are developed.

Similarly, the International Organization of Securities Commissions (IOSCO) established a task force on financial benchmarks in 2012. The task force, which is co-chaired by Martin Wheatley of the U.K. FCA and Gary Gensler of the U.S. CFTC, published a final consultative report on policy guidance and principles for financial benchmarks in April 2013.

Finally, in addition to these initiatives, the Bank for International Settlements, under the coordination of the Financial Stability Board, has set up a group of senior officials to examine reference rates used in financial markets.
Summary Positions

To inform regulatory reform initiatives associated with benchmarks and indices, CFA Institute has surveyed its global membership, submitted comment letters to regulatory authorities, and engaged in regulatory outreach with European and international regulators. Our positions are summarised as follows:

Transparency over Benchmark-Setting Processes

CFA Institute believes that greater transparency over the calculation and production of benchmarks and indices in general, particularly where indices are based on subjective or judgmental inputs, is a key element to uphold integrity.

- Actual transaction data should be used in the compilation of benchmarks (where relevant) to the fullest extent possible.
- Producers of benchmarks should provide sufficient transparency for users to be able to clearly understand and evaluate the methodology used to compile the benchmark.

Governance, Administration, and Management of Conflicts of Interest

In general, the following measures are necessary for benchmark integrity:

- Effective controls and separation of benchmark data submitters from trading desks;
- Management and supervision of relevant personnel along with a credible whistle-blowing policy and complaints procedure;
- Appropriate reporting and cooperation with relevant authorities;
- Monitoring, reviews, and audits of submissions processes;
- Appropriate documentation and record-keeping;
- Transparency through reporting to the public, to the market, and to regulators.
- Benchmark administrators and submitters should adhere to a code of conduct, and be subject to regulatory oversight where relevant.

Regulation

Benchmarks that are systemically relevant (i.e., are widely used or followed among different stakeholders or across markets or countries), that are based on subjective inputs (i.e., non-transaction data), and that are not adequately covered under existing financial market regulations (such as trade reporting and market abuse regulations under existing securities and derivatives markets legislation) should be the main candidates for additional regulatory oversight.

- Regulators should have powers to pursue criminal sanctions in cases of manipulation of interest rate benchmarks such as LIBOR and EURIBOR.
- Regulators should limit themselves to the regulation of index production (where appropriate as outlined above) and not step into invasive regulation of index choice or limit index use.